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New Numbers Support Tax Relief

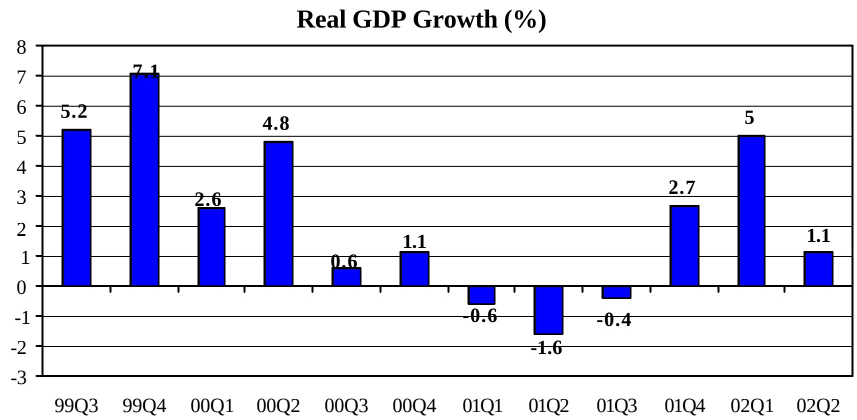
July's revised economic data from the Commerce Department provide new evidence that last year's tax cuts were exactly what the economy needed at exactly the right time. These new numbers demonstrate, contrary to earlier estimates, that last year's recession started sooner and lasted longer than previously thought. Moreover, the primary weakness in the economy was in business investment, not personal consumption.

The revisions reinforce the Bush Administration's push to enact sizable tax cuts targeted at reducing marginal tax rates on income and investment. Those tax cuts have helped raise investment and job creation above the levels where they otherwise would be.

These revisions also expose the irrelevance of alternative proposals that were offered by Senate Democrats. During the debate, Democrats argued that the best way to help the economy was to stimulate demand by targeting temporary benefits at low-income Americans who have a higher propensity to consume. We now know those arguments were wholly without merit. Last year's recession was driven by a collapse of investment, not consumption.

New Economic Data

The July 29th GDP report from the Department of Commerce significantly revised downward the previous national income estimates from 2001. After the revisions, first quarter real GDP fell 0.6%, second quarter fell 1.6%, and third quarter fell 0.4%. These lower numbers replaced previous estimates of 1.2%, 0.3%, and –1.3% respectively.



In other words, the weak economy began much sooner than previously thought, and the weakness was stronger than previously believed. As shown on the chart, the economy peaked the last three months of 1999, followed by a general decline in economic activity until the second quarter of 2001. It then reversed course again, growing in the last quarter of 2001 (even after 9/11!) and the first two quarters of this year.

Tax Cuts to the Rescue

For policy makers, the new numbers reinforce the correctness of the timing, size, and content of the Bush tax cuts. The new data suggest last year's tax cuts were adopted at exactly the time when the economy was at it lowest.

Timing: The new estimates show that President Bush inherited a shrinking economy. Prior to the release of these new estimates, the National Bureau of Economic Research had cited March of 2001 as the start of the recession. It now appears that the recession started much earlier, perhaps January. Considering that President Bush was not sworn into office until January 20th of that year, attempts by Senate Democrats, including Majority Leader Daschle, to blame his policies for the recession look pathetic in retrospect. On the other hand, the quickness with which the Administration proposed, and the Republican Congress adopted, President Bush's package of tax relief resulted in the package becoming law exactly when economic activity hit bottom – during the summer of 2001.

Size: Democrats argued repeatedly that reducing the tax burden on American families would result in higher levels of federal debt and higher interest rates. Those higher interest rates, in turn, would act as a tax on all Americans through higher mortgage and car payments. Conventional wisdom – at least in the Democratic Party – has it that increases in federal debt are tied to increases in interest rates. Ostensibly for that reason, Democrats supported tax relief that was both smaller and temporary.

Recent experience, however, argues that the "conventional wisdom" of tying federal debt together with interest rate levels is wrong. During the 1980s, for example, interest rates dropped rapidly even as government debt rose. The same counter-intuitive movement is occurring right now. Mortgage interest rates are at their 40-year low even as the federal budget has shifted from large surpluses to large deficits. The bottom line is fiscal policy makes for a very poor monetary tool. As has been written here previously, temporary fluctuations in government debt levels do not move interest rates. [See RPC paper: *Do Tax Cuts Cause Higher Interest Rates? No!*, January 17, 2002.]

The new Commerce Department numbers show that the economy was much weaker than previously believed. Economists have debated for the past year whether the United States actually experienced a recession in 2001, as the National Bureau of Economic Research certified. That debate is over. Not only did a recession occur in 2001, it started earlier and lasted longer than prior estimates. In the fight over how much tax relief was required, the fact that President Bush inherited an economy that was worse than previously believed has validated his push for a larger, permanent tax relief package.

Content: The Bush tax cuts were designed to stimulate investment and job creation by reducing marginal tax rates on personal income and business investment. Democrats argued that these tax cuts would be less effective than their competing proposals designed to address a shortfall in consumption. A typical example of that argument is contained in a letter Princeton economist Alan Krueger wrote to the Senate Democratic Policy Committee: "Because low-income workers have a high propensity to consume from additional income, this type of tax relief would be particularly helpful at stimulating spending."

The revised estimates from the Commerce Department refute the notion that low consumption levels starved the economy in 2001, just as the estimates support the Bush approach of reducing record tax burdens on investment and income. According to the Commerce Department, changes in Personal Consumption Expenditures remained positive throughout years 2000 and 2001, averaging 3.2 percent growth per quarter and never dropping below 1.4 percent in any one quarter.

On the other hand, Gross Private Investment dropped dramatically over the past two years – declining at double-digit rates in three of the four quarters last year while averaging a negative 6.2 percent. The Bush tax cuts targeted the very part of the economy that was the weakest – business and personal investment.

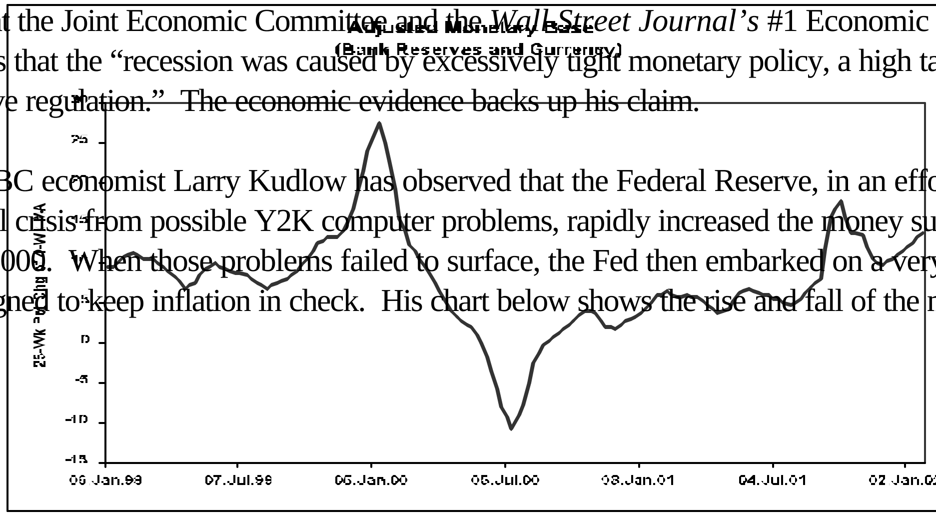
What Caused the Recession? What About the Government?

One question not addressed by the new data is just what caused the recession. Since the economy began shrinking prior to President Bush taking office (and almost six months prior to enactment of his tax cuts), Democrat charges that Bush's policies were the cause of the economic downturn cannot be taken seriously.

Instead, more fundamental causes are probably to blame. Brian Wesbury, former Chief

Economist at the Joint Economic Committee and the *Wall Street Journal's* #1 Economic Forecaster in 2001, argues that the "recession was caused by excessively tight monetary policy, a high tax burden, and excessive regulation." The economic evidence backs up his claim.

CNBC economist Larry Kudlow has observed that the Federal Reserve, in an effort to offset any financial crisis from possible Y2K computer problems, rapidly increased the money supply prior to January 1, 2000. When those problems failed to surface, the Fed then embarked on a very tight regime designed to keep inflation in check. His chart below shows the rise and fall of the monetary base.



The result was a Y2K monetary roller coaster. While inflation never became a problem, the rapid expansion and contraction of the money supply affected investment and the stock markets, first driving up investment and helping to create the "irrational exuberance" Fed Chairman Greenspan worried about and then pulling the rug out from under both.

Meanwhile, Wesbury is right to point at the tax burden. Senate Democrats spend lots of energy decrying the excessive size of the tax cuts. Their time would be better spent worrying about the excessive tax burden on American families. The Congressional Budget Office estimates that federal taxes – absent the Bush tax cuts -- would have consumed 20 cents of every dollar Americans earned over the next decade.

Even with those tax cuts, the federal government will still take 19 cents of every dollar earned. That is a record tax burden. It is higher than any decade since World War II. Far from cutting taxes too much, last year's tax bill merely moved us halfway toward the post-WWII average tax burden of 18 cents per dollar earned.

Finally, while federal regulations on labor and investment are a chronic burden on economic activity, the final months of the Clinton Administration saw an explosion of government regulation. Susan Dudley from the Mercatus Center at George Mason University has observed:

> Sudden bursts of regulatory activity at the end of a presidential administration are systematic, significant, and cut across party lines. But the magnitude of Clinton's activity has set a new record. The Clinton administration published 26,542 pages of regulations in the Federal Register [in its last months of] November, December, and January. That eclipses President Jimmy Carter's 20-year record for most pages published in the last three months of an administration, and represents a 51-percent increase over Clinton's average volume during the same period in the previous three years.

Focus on the Fundamentals

Record tax burdens, record regulatory rulemaking, and excessively tight monetary policies are bad for any economy. Last month's Commerce numbers show how they hurt the U.S. economy much sooner and harder than previously believed.

In the nineteen months since President Bush took office, his administration has worked with Congress and the Federal Reserve to address all three issues. The Bush Administration pushed through significant tax relief targeted at the weakest part of the economy. And they embarked upon a systematic review of all the rulemaking pushed through in the last few months of the Clinton Administration. Meanwhile, the Fed reversed its tight money policies and cut interest rates. The resulting economy has gone from negative growth in early 2001 to positive growth in all three quarters following 9/11.

While that's progress, certain areas of the economy remain weak, especially in manufacturing and employment. Much of the President's economic forum held last week in Texas focused on the need to stimulate investment and job creation. His comments following the summit suggest he will propose a new round of pro-growth policies to Congress, perhaps as early as this fall. Based on the record of who was right in 2001, those policies deserve to get a friendlier reception from Senate Democrats this time around.

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